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COMMERCE FOR 4201/ITA/IEP/OEERIS/BISNIS/MWALTERS
MOSCOW, KIEV, TBILISI, BAKU, ANKARA AND ISTANBUL - PASS
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SUBJECT: ARMENIA: DOUBLE DIGIT GROWTH

SUMMARY

1. Armenia's 2003 economic performance exceeded all predictions; despite the rounds of elections and political tremors during the year, the real Gross Domestic Product (GDP) grew by 13.9 percent, a record high since 1991 independence. Construction (mostly donor financed) and industry contributed to the growth by about 6 and 4.5 percentage points respectively. The external sector expanded by more than 30 percent, with exports growing faster than imports. The economy posted positive trends in labor and financial markets as well. The major price indices, however, show sharp increases: the Consumer Price Index (CPI) grew by 8.6 percent, while the Producer Price Index (PPI) jumped by 21.1 percent, the highest annual inflation rate since 1998. End Summary.

MACROECONOMIC OVERVIEW: CONSTRUCTION DRIVES GROWTH

2. Although the annualized economic growth rate declined by the end of December compared to November, the annual growth rate finished the year at 13.9 percent, the highest since independence. The growth pattern, however, was volatile in the first half of 2003, fluctuating from 7.5 percent in February to 14.9 percent in June. In the second half of 2003 the growth rate was relatively stable hovering around 15 percent.

3. As in 2002, industry and construction continue to drive growth. Year-on-year construction growth was roughly 40 percent from January to December 2003 (with residential construction growing by nearly 80 percent). Diaspora-based Lincy Foundation financing supported most of the growth in construction. Private construction almost doubled, however, responding to demand and sustained price increases in the real estate market. (Note: Construction as a share of GDP is estimated at 14.4 percent. End Note.)

4. Production of industrial goods increased by 14.9 percent with the level of electricity production was unchanged. Within the manufacturing sector, tobacco output was up 37 percent in volume terms, rubber and plastic by 125 percent, metal processing by 46 percent and machinery by almost 26 percent. These high rates are partly attributable to a depressed base-period, but also reflect considerable new investment in these sectors. Industry has by far the largest share of GDP, 24.1 percent. Agriculture, constituting about 21 percent of GDP, grew at 4.3 percent, despite pessimistic forecasts due to an unusually cold winter in 2002-2003. Retail trade and services also grew strongly (about 13 percent), indicating a consolidation of domestic demand.

INFLATION: BREAD PRICES HIT THE CONSUMER BASKET

5. Monthly price trends followed seasonal patterns in deflationary summer. In September, however, when the trend is also usually deflationary, prices rose by 2.5 percent, owing to a sharp jump in prices for bread and related products. This brought year-on-year inflation in September to more than 7 percent. Although in September international financial institutions as well as the Central Bank of Armenia (CBA) gave various forecasts of up to 7 percent inflation for the year, inflation for the rest of the year continued its trend with the highest monthly price increase of 5.3 percent in December. That brought the annual cumulative inflation to 8.6 percent, the highest since 1998.

6. An estimated 5 percentage points of the inflation is explained by an increase in wheat prices in Russia,

the main trade partner in this category. Wheat products represent nearly 20 percent of the CPI basket, and aggregate prices for this group increased by more than 25 percent in 2003. In early September the governor of the CBA, Tigran Sarkissian, said that there was no need to adjust monetary policy for 2003, implying only "moderate" growth in the money supply to neutralize inflationary pressures. He referred to the price increase as a "temporary external shock," without which the CPI would be in line with the targeted level of 3 percent. (Note: According to the Monetary Policy Program, the CBA forecasts 7 percent inflation in 2004, mostly due to anticipated increases in gas and water tariffs. End Note.)

17. The GDP deflator, the indicator of price changes on all products, increased in December by 0.2 percentage points, bringing annualized growth in the deflator for January-December to 4.7 percent, the highest since 1998. The Producer Price Index, an indicator of cost-driven inflation, also trended upward by the end of the year, increasing by 21.1 percent, the highest level since 1998.

EMPLOYMENT: NUMBERS MIXED, BUT GENERALLY HIGHER

18. According to the National Statistics Services (NSS), 10.1 percent of the active population, or 124.8 thousand people, is currently unemployed, compared to 9.4 percent in 2002. Although this may appear paradoxical in a period of high growth, the NSS finally incorporated the 2001 Census results into the unemployment calculus, according to which the denominator used, active population, decreased from about 1.4 million in 2002 calculations to 1.24 million in 2003. Applying the new numbers back to the 2002 estimate, the unemployment rate would come to 10.8 percent. Thus, over the course of 2003, real unemployment decreased by 0.7 percent. (Note: Official unemployment counts only those who receive unemployment insurance, not all those who are looking for jobs. End Note.)

EXTERNAL SECTOR: RUSSIA LOSES MARKET SHARE

19. Armenia's trade turnover expanded rapidly in year-on-year terms, with growth driven mainly by a substantial increase in trade in precious stones and metals. According to official data, export revenue was up by 34.2 percent at USD 678.1 million, well above the USD 590 million projected by the CBA. Import expenditures grew at about 28.6 percent to USD 1.3 billion. Precious metals and stones continue to dominate Armenia's trade structure: about 52 percent of export growth and 41 percent of import growth is attributed to precious stones and metals. The sector has benefited from stable supplies of stones from its main sources: Israel, Belgium and Russia.

110. Russia, although it remains Armenia's largest trade partner, lost market share for the second year in a row. Russia's total trade share decreased from 19.2 percent in 2001 to 17.3 in 2002 and 15.5 (or USD 302.3 million) in 2003. Imports from Russia, although they increased in dollar terms, decreased as a share of total imports from 19.5 percent in 2002 to 16.4 percent (or USD 207.7 million) in 2003. Israel became the largest export partner for Armenia, with total exports of USD 142.3 million, up by about 84 percent. Belgium and the USA remain the third and fourth trade partners in terms of exports.

FINANCIAL SECTOR: DECREASING INTEREST RATES AND STABLE ARMENIAN DRAM (AMD) HERALD LOWER COUNTRY RISK

111. During 2003, the CBA twice revised its refinancing rate, eventually cutting it from 13.5 percent to 9 percent in August. The policy was designed to stimulate the demand for money in the economy, increasing money supply (M2) by 28 percent. (Note: This provided yet another reason for increased inflation. End Note.) In 2003 most interest rates declined, including deposit and money market rates. Nevertheless, high credit risks and the poor quality of financial management between banks and enterprises kept lending rates high, thus increasing profits in the banking sector.

112. The Armenian national currency, the Dram (AMD), fluctuated within a narrow band against the USD during the year. In August a nominal depreciation of 4.2 percent year-on-year was recorded, partly reflecting

inflationary expectations. By the end of September, however, the rate stood at AMD 570/USD 1, an appreciation of almost 2 percent, mostly due to USD inflow to the country via transfers and tourist spending. (Note: According to the NSS, the number of tourists in 2003 increased by about 27 percent to 205,000. End Note.) The AMD lost value during the usual Christmas and New Year shopping frenzy, sliding back to normal rates immediately after the holidays.

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